A REGULATOR'S VIEW OF LIQUIDITY

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The textbook definition of liquidity is straightforward: The ability to provide sufficient funding at reasonable cost in a reasonable period. The definition is simple, but liquidity can be one the more challenging areas of the bank to manage. Maintaining sufficient liquidity is difficult enough under normal circumstances, but what do you do when:

In the days following the October 1987 stock market crash, a radio DJ decides to select your bank and broadcast false stories of crowds forming at your door demanding their money? Fictitious stories of a bank run turned into the real thing.

*What do you do?*

A relatively new bank has a bad quarter of credit losses and faces a major setback in profitability. Its largest correspondent bank cancels its line of credit, other sources of borrowings follow suit, and suddenly the bank's sources of liquidity are cut off except for what is on their balance sheet. *What do you do?*

September 11, 2001: Following the terrorist attacks on our country, a number of banks called our office wanting to know if they should close temporarily. Rumors of bank runs were starting. *What do you do?*

We experience a prolonged economic downturn and recovery is slow.  What do you do, or rather, *what are you doing?*

The foregoing examples are real.  They are examples of the kinds of things bank management must consider in their liquidity planning.  <u>Plan for the expected but prepare for the unexpected.</u>

In our view, banks can provide for their liquidity needs by either of two methods: STORED liquidity or PURCHASED liquidity.  STORED liquidity uses on-balance sheet liquid assets and a well-crafted deposit structure to provide all funding needs.  PURCHASED liquidity uses non-core liabilities and borrowings to meet funding needs.

Let's look at Stored Liquidity first.  Its advantages include:

1. Management has control of its funding.  All funding tools are readily available and they are highly immune to outside forces.  2.  They're available in good times and bad.  These types of liquid assets include Fed funds sold, investment securities, "due from accounts," and other sources such as cash flow from maturities of investments and loans.  Using STORED liquidity is still considered the safest way to provide your liquidity needs, and it is a simpler strategy to manage than purchased liquidity.

Disadvantages include: 1.  The amount of equity capital required to support the volume of assets needed. (although under Risk-based capital rules, the more liquid the asset, generally the less capital is required). 2. The additional interest rate risk that may be incurred by having a large volume of liquid assets on your balance sheet. 3. Opportunity cost. Keeping a large volume of liquid assets on your balance sheet isn't the most profitable way to deploy your assets. 4. Your market area must provide sufficient core deposits such that little or no borrowing is needed. (Much easier said than done!) Banks using Stored liquidity must deal with the following issues:

1. The current low rate on Fed funds sold. FFS is not an efficient way to provide large amounts of liquid funds.

2. Whether the investment securities are AFS or HTM, and the level of pledging to secure certain liabilities. Pledged securities are not considered liquid assets.

STORED liquidity is best and most often used by newer banks which normally have the capital needed to support the assets. Liquid assets are easily added to a new bank's balance sheet. Also, newer banks do not yet have a track record in the industry, and some forms of borrowing may not yet be available to them.

Now let's consider the advantages and disadvantages of PURCHASED funding sources.

These sources typically include Fed funds purchased, Federal Home Loan Bank (FHLB) advances, brokered deposits, Internet CDs, and other forms of borrowing.  Let's look at each one.

Fed funds purchased:  Good for short-term only and, similar to FFS, are not efficient for large amounts of borrowings.

Brokered deposits:  Available without restriction to "Well Capitalized" banks only. Brokered deposits can have their place in a well thought-out funding strategy, but are generally expensive and best used only when other sources are not available.

Internet CDs: Similar to brokered deposits – must be used carefully.  Internet CDs and so-called "national market" CDs can be cost-effective sources of funds, but the funds must be carefully invested so that amounts and maturities closely match that of the borrowing while preserving the spread.

Federal Home Loan Bank Advances:  This is one of the most widely used forms of non-core funding.  It can be "customized" for each bank's funding needs, and is predictable in terms of maturity and cost.  Its disadvantages are that the bank must pledge some of its highest-yielding assets, and the terms may carry certain embedded options, such as substantial prepayment penalties.

The most detrimental feature of FHLB advances is their sensitivity to the asset quality of the bank.  If asset quality deteriorates, the FHLB may refuse to renew the advance, raise collateral requirements, or reduce the line of credit.

(Think of an FHLB advance at your bank like a home equity line of credit on your home. Such financing CAN be part of a well-conceived strategy; but remember, you ARE mortgaging your best assets, ***and*** you are reducing your financial flexibility. FHLB advances are useful tools, but use them wisely).

And finally, borrowing, or purchased liquidity, should be considered a supplemental source of funding and not to be over relied upon. One suggested rule of thumb is to limit any single non-core funding source to a percentage of assets no greater than the bank's total risk-based capital ratio, subject to a prudent aggregate maximum.

So what's the best way to provide liquidity for your bank? STORED or PURCHASED?

Actually both; but neither one to the exclusion of the other. Each method has its advantages and disadvantages. Regulators are looking for a combination of the two methods. For most banks, a balanced approach to a liquidity strategy is the most cost effective and lowest risk method. Using a smart mix of a number of sources will cover the ongoing, daily liquidity needs as well as the needs when unforeseen events arise.

That's how banks should provide for their liquidity. *So how do regulators measure it?*

For starters, we're getting away from OVER RELIANCE on ratio analysis to measure liquidity. We still use ratio analysis, but examiners need to look behind the numbers and understand the bank's overall funding strategy. For years examiners relied on "The Liquidity Ratio" to evaluate a bank's liquidity. We insisted on at least 25% **net short-term liquid assets to net short-term deposits and liabilities.** Somehow 25% was OK, but 24% was not.

Times have changed. Market conditions have changed. Bank funding strategies have HAD to change. Regulators must change as well. What do regulators look for when evaluating a bank's liquidity?

QUALITATIVELY:

1. Diversified sources of funding that together provide the bank's needs under a variety of conditions.

2. A well-devised liquidity and funds management policy that covers both routine and emergency needs.

3. Established limits governing the types and amounts of liquid assets to hold, and limits regarding types and amounts of non-core funding.

4. Defined responsibilities for monitoring, measuring, and management reporting of all liquidity matters. And QUANTITATIVELY,

5. Commonly accepted (on the Uniform Bank Performance Report) liquidity ratios maintained within reasonable limits that, taken together, reflect a safe and sound funding strategy that provides ample liquidity while incurring minimal risk.

So after reviewing all that in the bank, how do we rate liquidity?

**"1" Rating:** Strong liquidity levels (stored and purchased) with well-developed funds management policies and practices.

**"2" Rating:** Satisfactory liquidity levels and funds management practices. Modest weaknesses are noted.

**"3" Rating:** All liquidity measurements need improvement. There is lack of ready access to funds at reasonable cost and in reasonable time, or other significant weaknesses in funds management practices.

**"4" Rating:** All liquidity measurements are deficient.

**"5" Rating:** All liquidity measurements are critically deficient and the viability of the institution is in question.

So there is a quick summary of what regulators look for when evaluating bank liquidity, how we measure it quantitatively and qualitatively, and how we rate it.

Questions and Answers